United States Court of Appeals

for the Second Circuit

AMICUS BRIEF

ORIGINAL

74-1537

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P/S

United States Court of Appeals
FOR THE SECOND CIRCUIT

RENEE SLADE,
Plaintiff-Appellee,

against

SHEARSON, HAMMILL & CO., INC.,
Defendant and Third-Party Plaintiff-Appellant,

against

NATIONAL BANK OF NORTH AMERICA,
Third-Party Defendant.

EDWARD E. ODETTE,
Plaintiff-Appellee,

against

SHEARSON, HAMMILL & CO., INC.,
Defendant and Third-Party Plaintiff-Appellant,

against

NATIONAL BANK OF NORTH AMERICA,
Third-Party Defendant.

ON APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

BRIEF OF SALOMON BROTHERS AS *AMICUS CURIAE*

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BRIEF OF SALOMON BROTHERS AS *AMICUS CURIAE*

Preliminary Statement and Position of Salomon Brothers as *Amicus Curiae*

This interlocutory appeal involves the following certified question:

> Is an investment banker/securities broker who receives adverse material non-public information about an investment banking client precluded from soliciting* customers for that client's securities on the basis of public information which (because of its possession of inside information) it knows to be false or misleading?

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* The use of the word "soliciting" in the certified question is unfortunate. Although it is clear from the record below and the briefs of the parties (see, *e.g.*, Shearson's Brief, pp. 6, 13, 16) that in the case at bar the word is used in the sense of the securities firm having affirmatively "suggested" and "recommended" the purchase of the particular securities in question, "soliciting" and "solicit", when used as technical words of art in the securities laws, may have a quite different—and in this case, unintended—meaning. Thus, for example, under Rule 144 of the General Rules and Regulations promulgated under the Securities Act of 1933, a broker who merely contacts a customer to determine if a customer is interested in buying a particular security—a common practice of block traders who regularly notify customers of the availability on the market of a list of blocks—is technically engaged in "solicitation" even though no recommendation of purchase is made. To avoid confusion, Salomon Brothers in this brief will use the word "recommend" rather than "solicit" to describe the conduct presented upon this appeal and Salomon Brothers would respectfully urge that this Court do likewise in answering the certified question.

The difference is not simply semantic: as will be developed in this brief, it is the fact of an affirmative *recommendation* to purchase having been made by Shearson's broker-dealer department when Shearson's investment banking department was possessed of material adverse information that in Salomon Brothers' view renders correct the decision of the District Court. See Point I, *infra*. Absent such *recommendation*, as will be set forth in Point II, *infra*, the "Chinese wall" device would properly serve to meet the requirements of the securities laws—whether or not a technical *"solicitation"* in the Rule 144 sense had taken place.

In essence, the issue involved upon this appeal is the legitimate bounds of the "Chinese wall" doctrine as a device for the separation of information as between the investment banking and broker-dealer departments* of a securities firm. It is the position of appellant Shearson that —having erected such a "Chinese wall"—it was entitled to have its broker-dealer department affirmatively recommend and promote purchases of a security on the basis of "public" information notwithstanding that its investment banking department on the basis of "inside" material adverse information knew the "public" information to be false and misleading.

It is the position of *amicus* Salomon Brothers that appellant Shearson seeks to extend the "Chinese wall" device beyond legitimate bounds; that the District Court correctly ruled that the "Chinese wall" device could not operate to immunize affirmative misrepresentation; and that accordingly the decision of the District Court should be affirmed and the certified question answered in the affirmative.**

Nonetheless, it is likewise the strong position of *amicus* Salomon Brothers that the "Chinese wall" device—properly limited—has a perfectly legitimate, and indeed indispensable, role to play in the securities industry. Fearful that this legitimate role may not be set forth for this Court's consideration by the actual adversaries in this litigation and that this Court might thus inadvertently find itself rendering an opinion containing language unintentionally going beyond the issues necessary to be adjudicated but having the gravest consequences to the securities industry, Salomon Brothers desires respectfully to set forth its views on the issues as an assistance to this Court.

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* As used herein "broker-dealer department" refers to the sales and trading operations of a securities firm.

** As previously noted, with the substitution of the word "recommending" for "soliciting". See p. 1, fn., *supra*.

Amicus Salomon Brothers does not have any actual knowledge of the facts in this case, and the statements made in this brief as to the facts of this case have been made on the basis of the record.

In Point I of this brief, Salomon Brothers will urge that the decision of the court below is correct on the postulated facts and circumstances of the certified question: *i.e.*, that a "Chinese wall" cannot be used to insulate a securities firm from liability for *recommending* the purchase of a security to customers on the basis of public information which is known to the securities firm to be false. In Point II of this brief, Salomon Brothers will nonetheless set forth:

> that the proper functioning of the securities industry and capital markets requires that securities firms be in a position to render the dual services of investment banker and broker-dealer;
>
> that the "Chinese wall" between investment banking and broker-dealer departments, properly circumscribed, is an appropriate device to permit this dual function to be performed consistent with the federal securities laws and public policy; and
>
> that—where the "Chinese wall" between investment banking and broker-dealer departments is scrupulously observed and the broker-dealer department refrains from making recommendations with respect to the security involved—the fact of confidential information possessed by the investment banking department should not operate to prohibit the broker-dealer department from executing transactions desired to be executed by a customer.

It is submitted that clarification by this Court of the legitimate role of the "Chinese wall" device by securities firms is not only of crucial importance to the securities industry, but is highly desirable as well in terms of judicial administration.

The Business of Salomon Brothers

Salomon Brothers is one of the largest securities firms engaged in most aspects of the securities business, dealing almost exclusively with business corporations and financial institutions. A substantial portion of Salomon Brothers' business is in the area of investment banking and underwriting. According to the annual Corporate Financing Directory of the Institutional Investor, Salomon Brothers in 1973 had the second largest underwriting volume of any firm in the nation. Salomon Brothers also engages in trading activities and is recognized in the industry as a major market maker or block positioner in all investment grade securities.

Having long been highly sensitive to the problems posed by the potentiality of the broker-dealer department being engaged in activities with respect to securities of companies as to which the investment banking department might hold confidential inside information, Salomon Brothers has devised policies which would permit the firm to meet its obligations of confidentiality to investment banking clients while scrupulously avoiding even the possibility of misuse of inside information for the trading advantage of the firm or any of its customers. The keystone of such policies is the "Chinese wall" between the investment banking and broker-dealer departments which prevents the transmission of any inside information to the broker-dealer department and thus renders impossible any misuse of such inside information by the firm or its customers. Recognizing, however, the other edge of the sword —to wit, Salomon Brothers' obligation not to mislead its trading customers in the situation where the investment banking department might be possessed of material inside information which, by definition, would not be known to the broker-dealer department—Salomon Brothers has a policy of not recommending securities about which it is

likely to obtain material inside information through an investment banking or similar relationship. Salomon Brothers thus precisely guards against a situation such as that presented by the case at bar: Shearson's broker-dealer department affirmatively *recommending* the purchase of a security to customers on the basis of public information known by Shearson's investment banking department to be false and misleading. To further guard against a situation such as presented by this case, Salomon Brothers, as do many securities firms, supplements its "Chinese wall" with a "restricted list" procedure. The "restricted list" procedure has been devised for three principal purposes: (1) to prevent violations of Rule 10b-6 which proscribes certain trading activities by a securities firm engaged or likely to be engaged in an underwriting or other "distribution" of securities; (2) to assure that inside information is not used improperly; and (3) to assure that the firm does not make recommendations contrary to inside information. The restricted list is circulated to all departments of the firm and constantly updated and revised so that no department will violate the pertinent restriction as to any security on the restricted list. It has been Salomon Brothers' experience that it is readily able to inform a customer that Salomon Brothers cannot execute a transaction at a particular time because the security in question is on the restricted list without that information by itself being taken as either a buy or sell signal.

ARGUMENT

POINT I

The broker-dealer department of a securities firm may not affirmatively recommend and promote the purchase of a security based upon public information known to the firm's investment banking department to be false and misleading.

It is the position of Salomon Brothers that the holding of the District Court, on the facts postulated before it, is fully consistent with the purposes underlying Rule 10b-5 as interpreted both by this Court and by the Securities and Exchange Commission (the "Commission").

Trading or making a recommendation on the basis of inside information violates Rule 10b-5. See, *e.g.*, *Shapiro* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228 (2d Cir. 1974); *SEC* v. *Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968), *cert. denied sub nom. Kline* v. *SEC*, 394 U.S. 976 (1969); *Cady, Roberts & Co.*, 40 SEC 907 (1961). It is thus clear that a brokerage firm may not execute transactions for its own account or for a discretionary account on the basis of inside information (*Cady, Roberts & Co., supra;* Sec. Exch. Act Rel. No. 8511 (1969)), nor may it pass such information on to others whether in the form of a research report or otherwise. *Shapiro* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc., supra; SEC* v. *Texas Gulf Sulphur Co., supra.* In addition, as the court below has correctly held, a firm may not recommend a security on the basis of public information if it knows on the basis of inside information that this public information is false and misleading. Indeed, such conduct is tantamount to common-law fraud. See *Black* v. *Shearson, Hammill & Co.*, 256 Cal. App.2d 262, 72 Cal. Rptr. 157 (Ct. App. 1968); *SEC* v. *Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 194 (1963); Prosser, Law of Torts 534-35 (2d ed. 1955).

Appellant Shearson, however, argues that if—upon learning the inside adverse information with respect to Tidal Marine—it had proceeded to "prohibit recommendation of purchases by the individual salesmen", this in and of itself would have constituted an impermissible "use" of the inside information proscribed by *Texas Gulf Sulphur* and its progeny. See Shearson Brief, pp. 16-17. *Amicus* Salomon Brothers cannot agree. Salomon Brothers does not believe that a doctrine formulated to *prohibit* a securities firm from using inside adverse information to "tip" a customer to *sell* was ever intended to be convoluted to mean that when a securities firm learns inside adverse information it is nonetheless *compelled* to allow its broker-dealer department to recommend a customer to *buy*. Any such holding, it is submitted, would turn *Texas Gulf Sulphur* on its head and render the inside information doctrine a license to commit common-law fraud.

Nor can the Hobson's choice claimed by appellant Shearson—that it could not *stop* recommendations of Tidal Marine stock by its salesmen without thereby improperly making "use" of its inside information—withstand analysis. Indeed, a simple answer to the supposed conundrum is to be found early in Shearson's own brief in which Shearson sets forth:

> Pursuant to its internal policies and procedures, the firm never recommends the securities of an investment banking client.
>
> —Shearson's Brief, p. 6

Unfortunately, however, it develops that Shearson construes the word "firm" in its above "policies and procedures" to mean the "firm" *except* for the firm's "Retail Sales Organization", which Shearson's brief insists upon viewing as consisting of quasi-independent "individual investment executives" being somehow disaffiliated from the "firm" and thereby being free to recommend the purchase of securities that the "firm" itself as a matter of its own

"policies and procedures" would be barred from recommending. See Shearson's Brief, p. 16. Thus, in Shearson's brief we are told—

> In the case at hand, individual investment executives also recommended the purchase of stock [of Tidal Marine, an investment banking client of Shearson] * * *.
>
> —Shearson's Brief p. 16

—and it is of course these continuing "recommendation[s] of purchases" that Shearson professes itself as having been powerless to *discontinue* upon learning the inside adverse information with respect to Tidal Marine without making improper "use" of that information to the unfair advantage of its customers. Shearson's Brief, p. 17.

The solution to the problem is obvious: the attempt by Shearson to view its own salesmen in its broker-dealer department as being somehow separate and apart from the "firm" itself is wholly artificial and is an exercise in semantic legerdemain. If Shearson had simply properly construed and abided by its own "internal policies and procedures" in the first place and refrained from having its salesmen make recommendations with respect to the securities of Tidal Marine or if Shearson had supplemented its "Chinese wall" with a restricted list as described *supra*, p. 5, then either there would have been no need to *discontinue* such continuing recommendations upon the investment banking department's learning the inside adverse information or once the information was learned the recommendations would have stopped.

Thus, Salomon Brothers submits that if appellant Shearson in the case at bar found itself between the Scylla of defrauding its trading customers and the Charybdis of making improper use of inside information learned from its investment banking client, the difficulty was of Shearson's own making. Had Shearson refrained from making recom-

mendations or used a restricted list to supplement its "Chinese wall", no such subsequent difficulty would ever have arisen.

In Point II of this *amicus* brief, Salomon Brothers will nonetheless set forth that comprehensive "policies and procedures" regulating a brokerage firm (including, of course, its broker-dealer department and the employees therein) with respect to recommendations of the securities of an investment banking client—if *complied* with—and when coupled with the interposition of a "Chinese wall" between the investment banking and broker-dealer departments, do permit such firm to perform both a broker-dealer and investment banking function consistent with the federal securities laws and public policy.

POINT II

The "Chinese wall" policy is valid and deserves judicial sanction. Provided that the firm has not recommended the transaction, the broker-dealer department which is in fact isolated from inside information pursuant to the implementation of a "Chinese wall" policy is not prohibited from executing a transaction for a customer in a security about which the investment banking department possesses inside information.

An understanding of the role played by Salomon Brothers and other multi-service firms in the securities industry is essential for appreciation of the consequences of the decision to be rendered on this appeal. These firms perform several functions vital to the American economy. In their investment banking capacity they play the key role in raising equity and long-term debt capital for American business. In their broker-dealer capacity, these firms assure investors of the ability to make and dispose of investments. These firms are essential to the liquidity

and normal functioning of the capital markets. As was stated by the Commission in its Statement on the Future Structure of the Securities Markets [Special Studies Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 74,811 at 65,623 (Feb. 2, 1972) (emphasis added) (hereinafter "SEC White Paper"):

> There are potential conflicts of interest in these relationships [brokerage and investment advisory functions], as well as in the broker-underwriter relationship, the money manager-underwriter relationship and the dealer-money manager relationship. *If all of these functions were to be separated, the capital-raising capability of the industry and its ability to serve the public could be significantly weakened.*

A. The "Chinese Wall" and "Tippee" Liability

Investors Management Co., Inc. [1970-1971 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 78,163 (1971), one of the leading Rule 10b-5 decisions by the Commission, *a fortiori* establishes the validity of the "Chinese wall" doctrine. In *Investors Management* the Commission found that Rule 10b-5 was not violated by an investment adviser who sold a security on the basis solely of his own investment decision based on public information, despite the fact that prior to the sale an employee of the investment adviser who had been "tipped" as to material inside information (but did not disclose that information to the investment adviser) had recommended the sale in question to the investment adviser. That the Commission in this decision said that

> we would view as suspect and subject to close scrutiny a defense that there was no internal communication of material non-public information and its source by a member of a broker-dealer firm or other investment organization who received it, where a transaction of the kind indicated by it was effected by his organization immediately or closely thereafter

does not detract from the precedental value of this case as to the "Chinese wall" but rather reinforces it. ¶ 78,163 at 80,522, n. 28. For the obvious corollary of the Commission's decision is that if it *were* proven after "close scrutiny" that there had in fact been "no internal communication of material non-public information" within the firm—as by a scrupulously observed "Chinese wall"—then there would be *no* "tippee" liability: It would have been conclusively demonstrated that the inside information had not been used.* See pp. 12-13, *infra*. Of course, no one contends that the "Chinese wall" protects from liability if in fact it was breached.

It is submitted, however, that neither the purpose of, nor the policy supporting, Rule 10b-5 requires prohibiting the broker-dealer department of a securities firm from continuing to execute transactions for customers if its investment banking or some other department—but *not* the broker-dealer department—is in possession of inside information with respect to the securities being traded. Indeed, the policy of fostering liquid securities markets and thereby facilitating capital formation for American business requires that such trading be permitted.

This Court in *SEC* v. *Texas Gulf Sulphur Co., supra*, expressed the policy underlying Rule 10b-5 in the following terms:

> The core of Rule 10b-5 is the implementation of the Congressional purpose that *all investors should have equal access to the rewards of participation in securities transactions.* It was the intent of Congress that

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* The *Investors Management* decision unequivocally establishes that the essential element of any tippee violation is that "the information be a factor in [the tippee's] decision to effect the transaction." ¶ 78,163 at 80,519. Manifestly, if the person making the investment decision is wholly unaware of the inside information—by virtue of strict adherence to a "Chinese wall"—the information by definition could not be "a factor" in his investment decision.

> *all members of the investing public should be subject to identical market risks* • • • [and] *inequities based upon unequal access to knowledge* should not be shrugged off as inevitable in our way of life, or, in view of the congressional concern in the area, remain uncorrected.
>
> —401 F.2d at 851-52 (emphasis added)

Such view was recently reaffirmed by this Court in *Shapiro* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc., supra:*

> [T]he purpose behind Section 10(b) and Rule 10b-5 is to protect the investing public and to secure fair dealing in the securities markets by promoting full disclosure of inside information so that an informed judgment can be made by all investors who trade in such markets. (citations omitted) We recently held in *Radiation Dynamics, Inc.* v. *Goldmuntz,* 464 F.2d 876, 890 (2d Cir. 1972), that "[t]he essential purpose of Rule 10b-5 • • • *is to prevent corporate insiders and their tippees from taking unfair advantage of the uninformed outsiders.*"
>
> • • •
>
> In short, whether invoked in an SEC injunction action or in a private damage action, "the Rule is based in policy on the justifiable expectation of the securities marketplace that *all investors trading on impersonal exchanges have relatively equal access to material information* • • •." *SEC* v. *Texas Gulf Sulphur Co., supra,* 401 F.2d at 848. See *Crane Co.* v. *Westinghouse Air Brake Co., supra,* 419 F.2d at 796.
>
> —495 F.2d at 235-36 (footnote omitted) (emphasis added)

It is clear from the foregoing that the objective of Rule 10b-5 is to assure equal *access* by the investing public to

material information and to prevent the *use* of inside information. Rule 10b-5 is thus not designed to inhibit normal transactions and the policy against acting on the basis of inside information is not violated if the broker-dealer department of a securities firm performs a normal market function and executes a transaction even though the investment banking or another department is in possession of inside information, so long as such inside information has not been communicated to the broker-dealer department. The inside information thus would not be *used* by the firm or its customer.

Many securities firms (including Salomon Brothers) have adopted the "Chinese wall" to provide for the isolation of any inside information in the departments that receive the same, principally the investment banking department. See McAtee, *Investment Bankers' Responsibilities Under the Federal Securities Laws*, in Goldberg, ed., *Expanding Responsibilities Under the Securities Laws* 283-313 (1973). The operative principle behind the "Chinese wall" is that the prevention of *access* to any inside information necessarily precludes the improper *utilization* thereof, thus obviating the evil at which Rule 10b-5 is directed. At the same time, the duty of confidentiality owed to the investment banking client is fulfilled.*

While under *SEC* v. *Texas Gulf Sulphur Co.*, *supra*, and *Shapiro* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, *supra*, the fact that a person was in possession of inside information at the time of or shortly after a transaction may lead to a presumption that such information was used

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* The securities firm owes a duty to its investment banking clients not to disclose inside information divulged to it. *Schein* v. *Chasen*, 478 F.2d 817, 823-24 (2d Cir. 1973), *vacated and remanded on other grounds sub nom. Lehman Bros.* v. *Schein*, 414 U.S. 1062 (1974). See *Diamond* v. *Oreamuno*, 24 N.Y.2d 494 (1969); N.Y.S.E., *M.F. Educ. Circ. No. 162* (June 22, 1962); Daum and Phillips, *The Implications of Cady, Roberts*, 17 Bus. Law. 939, 950 n.25, 952 (1962).

in connection with the transaction, those cases do not preclude a showing of *non-use* to avoid liability. See *SEC* v. *Shapiro*, 494 F.2d 1301 (2d Cir. 1974); *Investors Management Co., Inc.*, [1970-71 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 78,163 (1971). The "Chinese wall" is designed to foreclose the *use* of inside information and thereby to meet the standard of conduct established by these cases.

B. The "Chinese Wall" and Customer Liability

Turning to the other side of the coin, there is no reason why a customer should have recourse against a securities firm if the firm did not recommend the trade and at least if its broker-dealer department was not aware of the inside information. Indeed, the policy of assuring reliable and liquid trading markets requires that if an investor has determined to execute a transaction, he should be able to execute it promptly and at a current price and not be forced to spend time seeking a new securities firm to execute the transaction. *Cf.* SEC White Paper, *supra* at 65, 612-13; Staff of Subcommittee on Securities, Senate Comm. on Banking, Housing and Urban Affairs, 93d Cong., 1st Sess., Securities Industry Study Report at 11, 89, 197 (Comm. Print 1973). *See generally* SEC, Advisory Committee Report on the Structure of a Central Market System (1973); U.S. Treasury Department, Public Policy for American Capital Markets, BNA, 239 Sec. Reg. & L. Rep. D-1 (Feb. 13, 1974) (hereinafter "Treasury Study").

It might be argued that a securities firm in possession of inside information has a duty to dissuade a customer from executing a transaction if, on the basis of that information, the transaction should not in the customer's interest be executed. However, where the firm has not recom-

mended the transaction to the customer and in the absence of some special relationship, pursuant to which it is clear that the customer is relying on the firm for investment advice, the firm does not have any duty to advise the customer. *Cf. Canizaro* v. *Kohlmeyer & Co.*, 370 F.Supp. 282, 286-88 (E.D. La. 1974); Opinion, Comptroller of Currency, June 10, 1974, BNA, 257 Sec. Reg. & L. Rep. E-1, E-6 (June 19, 1974). See Jacobs, *The Impact of Securities Exchange Act Rule 10b-5 on Broker-Dealers*, 57 Cornell L. Rev. 869, 971 (1972); Daum and Phillips, *The Implications of Cady, Roberts, supra* at 952; Painter, *Inside Information: Growing Pains For the Development of Federal Corporation Law Under Rule 10b-5*, 65 Colum. L. Rev. 1361, 1388 (1965). Indeed if the firm took steps to dissuade such a customer it would not only breach its duty to the company from which it obtained the information, but also would in effect be making a proscribed recommendation. When a securities firm comes into possession of inside information it must remain neutral. The firm cannot give its customers the benefit of the inside information nor can it stop its customers from trading contrary to the inside information. Neutrality means just that: no recommendation to trade in the manner indicated by the inside information and no continuance of recommendations to trade in a manner contrary to the inside information. Even where a firm has an advisory relationship and therefore a special duty to a customer, such duty would not require it to perform an illegal act by disclosing inside information in violation of Section 10(b) and Rule 10b-5. *Investors Management Co., Inc., supra,* at 80,522. Moreover, if a firm were to dissuade a customer from executing a transaction on the basis of inside information, there is the added danger that the customer might communicate either the information or the fact of its existence (and whether it is positive or negative) to other persons who might use the information in violation of Section 10(b) and Rule 10b-5. The "Chinese wall" avoids the problem of selective dis-

closure to customers who happen to decide to trade during the critical period.

The analogous problem of the conflict between the inside information obtained by the commercial loan department of a bank and the investment management activities of the trust department need not be decided or alluded to here. However, it is instructive to note that all of the commentators who have considered that issue have found the "Chinese wall" to be a helpful tool for its resolution. See, *e.g.*, Lipton, *Commercial Banks' and Other Lenders' Responsibilities under the Federal Securities Laws*, in Goldberg, ed., *Expanding Responsibilities Under the Securities Laws* 257-82 (1973); PLI, *First Annual Institute on Securities Regulation* 326-28, 333-40 (1970); Lybecker, *Regulation of Bank Trust Department Investment Activities*, 82 Yale L.J. 977, 981-84, 1001-1002 (1973); Yellon, *Trust Investments: Problems Regarding Exchange of Information between the Trust Department and Other Departments within the Bank*, 54 Chicago Bar Record 405 (1973); Herman and Safanda, *The Commercial Bank Trust Department and the "Wall"*, 14 B.C. Ind. & Com. L. Rev. 21 (1972). Indeed, the recent Treasury Study, p. D 11-12, has concluded that:

> Public policy now prohibits communications of material "inside" information between the commercial side and the trust department for the purpose of influencing either investment or lending decisions. In the absence of more persuasive evidence than has been presented so far regarding the harmful effects of present arrangements, there is no reason to change public policy in this area.

See, also, Opinion, Comptroller of Currency, June 10, 1974, *supra;* Address by Ray D. Garrett, Jr., Chairman of the SEC, National Trust Conference, Feb. 7, 1974, [1973-74 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 79,641; Address by Commissioner John R. Evans, Second Annual Bank

Investments Conference, American Bankers Association, BNA, 241 Sec. Reg. & L. Rep. E-1 (Feb. 27, 1974); Statements of Commissioner John R. Evans and David S. Murphy before Subcommittee on Securities, Sen. Comm. on Banking, Housing and Urban Affairs, May 6, 1974, BNA, 251 Sec. Reg. & L. Rep. G-1 (May 8, 1974); Address by Commissioner John R. Evans, Ninth Annual Banking Law Institute, May 2, 1974, [1973-74 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 79,775.

As will now be detailed, the Securities and Exchange Commission, the New York Stock Exchange and the authorities concerned with securities regulation in England have considered carefully the "Chinese wall" question and determined that it is indeed the appropriate solution.

C. The Securities and Exchange Commission View

The Commission views the "Chinese wall" as a useful technique for the investment banker/broker-dealer. Thus, in its *Institutional Investor Study*, after reviewing the problems presented by *Cady, Roberts & Co., supra; SEC* v. *Texas Gulf Sulphur Co., supra;* and *Merrill Lynch, Pierce, Fenner & Smith, Inc.* [1967-69 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 77,629 (1968), the Commission stated:

> [These cases] suggest that institutions must consider whether they have received material, non-public information from inside sources. Such sources would not be limited to officers, directors and 10% owners, but, under the *Merrill Lynch* case, would include anyone having a special relationship to the company. *Institutions must also consider the necessity of segregating information flows arising from a business relationship with a company as distinct from information received in an investor or shareholder capacity. Thus, a bank that receives detailed operating information from a company under the terms of a loan agreement may have to prevent that information from being utilized by the bank's trust department;* if the informa-

> tion is material and non-public, its disclosure to the trust department investment officers might have the effect of contaminating any transactions in the company's stock by the trust department during the period of non-disclosure. *These problems are not insuperable; they do require a reasoned, systematic response by institutional investors.*
>
> —5 SEC, *Institutional Investor Study* 2539 (1971) (emphasis added)

Moreover, the Commission's Proposed Rule 17j-1 under the Investment Company Act of 1940, designed to combat the potential conflicts of interest faced by the investment company/investment adviser, advocates firms' adoption of codes of ethics, including, *inter alia*, "Chinese walls". See Investment Company Act Release No. 7581 (December 26, 1972). Section (d)(5) of the proposed rule further provides that a registered investment company, investment adviser or principal underwriter should not be considered to have violated the rule by reason of a violation of its code of ethics by an individual, if it establishes that it has instituted adequate procedures and used reasonable diligence to carry out the provisions of the code.

Finally, in *Merrill Lynch, Pierce, Fenner & Smith, Inc., supra*, the Commission accepted an offer of settlement submitted by Merrill Lynch which involved the adoption of procedures designed to protect "*against disclosure* of confidential information". Such procedures included a Statement of Policy, incorporated in the offer of settlement, which:

> [P]rohibits disclosure by any member of the Underwriting Division of material information obtained from a corporation in connection with the consideration or negotiation of a public or private offering of its securities and not disclosed to the investing public by the corporation, except to senior executives of registrant, its legal department, persons directly involved with the

> underwriters in connection with the proposed offering, Research Division personnel whose views in connection with the proposed offering are sought by the Underwriting Division, and members of the buying departments of prospective co-underwriters for the purpose of enabling them to decide whether they will participate in the proposed offering. Any employee of registrant who receives such information is subject to the same restrictions as provided for members of the Underwriting Division.
>
> —[1967-69 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 77,629 at 83,350 (footnote omitted)

The Merrill Lynch Statement of Policy is not inconsistent with the position urged by Salomon Brothers in Point I of this brief—that the "Chinese wall" approach should not be perverted so as to sanction continued recommendations which constitute active fraud. The Merrill Lynch Statement of Policy was drawn specifically for the purpose of insuring that the information obtained by the Merrill Lynch investment banking department was not used to "tip" Merrill Lynch customers—the situation that gave rise to the action by the Commission against Merrill Lynch. In addition, the provision in the Merrill Lynch Statement of Policy for disclosure of inside information to the legal department appears to be designed for the purpose of enabling the legal department, in cases where Merrill Lynch is recommending the security in question, to put the security on a restricted list and thereby avoid the problem faced by Shearson. The answer is fairly simple:

(1) A securities firm should have a "Chinese wall" policy;

(2) A securities firm should have a policy of not recommending securities about which it is likely to obtain material inside information through an investment banking or similar relationship; and

(3) In the special case where a securities firm is recommending a security and it nonetheless happens to obtain material inside information it should immediately terminate any further recommendations until the information has become public.

D. The New York Stock Exchange View

The New York Stock Exchange (the "Exchange") has long recognized the "Chinese wall" as an appropriate device for dealing with a recurring conflict situation faced by the member firm which has a director on the board of a company at the same time as the firm is making a market in or holds the stock of the company. As stated by the Exchange:

> 1. *Every director has a fiduciary obligation not to reveal any privileged information to anyone not authorized to receive it.* Not until there is full public disclosure of such data, particularly when the information might have a bearing on the market price of the securities, is a director released from the necessity of keeping information of this character to himself. Any director of a corporation who is a partner, officer or employee of a member organization should recognize that his *first responsibility in this area is to the corporation on whose Board he serves. Thus, a member firm director must meticulously avoid any disclosure of inside information to his partners, employees of the firm, his customers or his research or trading departments.**
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> —N.Y.S.E., *M.F. Educ. Circ. No. 162* (June 22, 1962) (emphasis added)

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* While the logical extension of this policy would support the position urged by appellant Shearson, logic should not overcome

(footnote continued on following page)

Thus, the Exchange suggests the non-communication of any inside information. In a later policy statement, moreover, the Exchange has indicated that these rules are specifically applicable in the broker-dealer investment banker context:

> Where a representative of a member organization is not a director but is active in an advisory capacity to a company and discussing confidential matters, the ground rules should be substantially the same as those that apply to a director. Should the matter require consultation with other personnel of the organization, adequate measures should be taken to guard the confidential nature of the information to prevent its misuse within or outside of the member organization.
>
> —N.Y.S.E., *Expanded Policy on Timely Disclosure* A-21 (July 18, 1968)

E. The English Approach

American authorities are not alone in their acceptance of the "Chinese wall". The English regulators have made a similar value judgment as reflected in the London City Code on Take-Overs and Mergers, administered by the City Take-Over Panel, and the proposed English Companies Bill, introduced in the House of Commons on December 18, 1973.

Appendix I to the City Code, entitled "The Use of Confidential Price-Sensitive Information", deals with the problems of merchant banks which acquire inside information (*e.g.*, a contemplated take-over) about particular com-

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(footnote continued from preceding page)

policy and be used to sanction active fraud by knowingly permitting employees to make false recommendations. In any event, the Exchange has apparently taken no position on whether the securities firm director with inside information should nevertheless act to prevent his firm from making false recommendations to customers.

panies for which they act as corporate advisers, or on whose boards members of the firm sit, while such firms are also engaged as investment advisers to customers. The Panel recognizes the inherent opportunity for abuse, as well as the rule against trading or recommending transactions on the basis of inside information. With respect to multi-service firms, it recommends (1) the greatest practicable degree of physical segregation of the activities of corporate and investment advising, and (2) that persons below Board level who are concerned with corporate advice and who may be aware of information have no connection with or responsibility for investment advice—*i.e.*, a "Chinese wall". The Panel, however, firmly *rejects* the contention that senior management and members of the Board should be denied access to information or that those firms engaging in corporate advising should be prohibited from also engaging in investment advisory activities. City Code on Take-Overs and Mergers, Appendix I, pp. 10-14.

Thus, the Panel recognizes that it is common for merchant bankers to wear two hats and the importance of dual functions and accepts the "Chinese wall" procedure as a solution to the conflict problem. It states:

> It is true that the existing practice in this country, as in the United States, does involve those concerned in the higher management of our Merchant Banks having dual capacities in which information received in the one is not to be used in the other. It may be claimed that this imposes an intellectual discipline on the individuals concerned which, however theoretically possible, it is quite impracticable to expect them to observe in every detail. And human fallibility and cupidity being what they are it is obviously impossible to guarantee that in every case this duality will not be abused. *Yet the "wearing of two hats" is something which is accepted by all economically ad-*

vanced societies and which in England is very far from limited to the merchant banking community. Wherever, whether in business, the professions or in public life, an individual stands in a confidential or sometimes even a judicial relationship to two or more interests, conflicts of interest of the kind canvassed here are bound to arise. In the vast majority of cases they are satisfactorily resolved. *The risk of occasional abuse is far outweighed by the manifold advantages which would be lost if duality of this sort were prohibited.*

• • •

It remains to add how all this works out in practice. Subject to the matter which is mentioned later, it was axiomatic in the case of every firm and individual who assisted in our enquiry that "inside" or confidential information obtained in the corporate advising capacity *was not to be used in the capacity of investment advising, still less in the personal investments of the firm or individuals concerned. This rule is generally recognized and accepted by the clients of either department.* In order to avoid the risks of mistake or abuse, the two functions are as far as practicable physically segregated in different departments and are the concern of separate executives. It is only those at director or partner level, • • • who can or may have to operate in a dual capacity. *There is some difference of practice in the case where knowledge of an imminent take-over transaction exists. Some Houses put the securities affected on a stop list so that all transactions in these by the Investment Department other than those ordered apparently in good faith by outside clients are precluded.* This practice may lead to the suspicion that "something is afoot" and may be unfair to investment clients who have left the management of their portfolios at discretion to be exercised by reference to

ordinary investment criteria.* Other Houses permit transactions to proceed normally but insist with special strictness that no information not available with normal diligence to the ordinary investment analyst or stockbroker should be taken into account and that each transaction must be capable of clear and public justification by reference to ordinary investment criteria. On one point, however, some difference of opinion did emerge. Was a director with knowledge of an impending bid or other significant "inside" information, who became aware that his firm's investment department was about to embark on sales or purchases which in the circumstances might prove to be disastrous, entitled to intervene or, if asked for his opinion, permitted without giving his reasons to give advice against the transaction? *The Panel has no doubt that the better, if Draconian, opinion is that in such cases the individual concerned must be completely excused from advising either way. The transaction should proceed in exactly the way it would have done if no one had in fact, been in possession of any inside information not available to others exercising due diligence.***

—City Code on Take-Overs and Mergers, Appendix I, pp. 12-13 (emphasis added)

The proposed Companies Bill (which has apparently lapsed with a change of government) attempts, *inter alia*, to deal with the problem of transactions in securities by persons with inside information. Part II, section 14(3) thereof, sets forth specific provision for proof of the exist-

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* Whatever the experience may be in England, there is nothing unusual about the use of restricted lists in the United States, and they are employed by many securities firms, including Salomon Brothers. Salomon Brothers has not had the experience of the restricted list being taken as a buy or sell signal. See *supra*, p. 5.

** As set forth in Point I, *amicus* Salomon Brothers does not agree that it is necessary or appropriate to carry the doctrine to this extreme.

ence and effective operation of a "Chinese wall" as a defense to charges of such dealings:

> A company should not be precluded * * * from entering into any transaction by reason only of, or of having obtained, any information in the possession of a director or employee of that company if—
>
> (a) the decision to enter into the transaction was taken on its behalf by a person other than the director or employee; and
>
> (b) arrangements were then in existence for securing that the information was not communicated to that person and that no advice with respect to the transaction was given to him by a person in possession of the information; and
>
> (c) the information was not in fact so communicated and advice was not in fact so given.

Moreover, Part II, section 14(2)(c) of the Companies Bill would permit a firm to execute an agency transaction even in the absence of a "Chinese wall", if the firm did not recommend the transaction. Thus, it states:

> Neither section 12 nor section 13 above shall preclude a person from entering into any transaction if * * * he enters into the transaction as agent for another person and has neither selected nor advised on the selection of the securities to which the transaction relates * * *.

In light of the above, it is clear that the English regulators have made the value judgment that potential conflicts are inherent in the legitimate functioning of financial institutions, that such potentiality can be effectively controlled through segregation of information in the various departments of such institutions, and that customers have no recognizable expectation that institutions will accord access and use of inside information to other departments. See Lipton, *English Company Law Reform Proposals*, 2 Sec. Reg. L.J. 16 (1974).

Summary

If multi-service firms are to continue to exist in the securities industry, a sound resolution must be found for the problem posed by their receipt of inside information. On the one hand, the firm may not use the inside information to "tip" its trading customers. On the other hand, if it refrains from sharing its inside information with such customers, does it relieve itself from all responsibility both under the federal securities laws and under common law fiduciary principles? Appellant Shearson urges that—having created a "Chinese wall" to guard against unlawful "tips"—it was then free to have its broker-dealer department affirmatively *recommend* to its customers the purchase of a security on the basis of "public" information known to its investment banking department to be false and misleading. *Amicus* Salomon Brothers believes that acceptance of such a position would unfairly tilt the scales against the legitimate interests of a securities firm's trading customers and would be tantamount to countenancing common-law fraud.

Nonetheless, Salomon Brothers urges this Court, should it affirm the decision of the court below, to exercise caution in limiting its determination to the particular facts and circumstances of a false recommendation presented by the case at bar. The "Chinese wall" device does have a legitimate and essential role to play in the securities industry. It is simply a matter of drawing a line between the competing interests at a point different—and more favorable to the trading customer—than that urged by appellant Shearson. Specifically, if a firm utilizes a "Chinese wall" thereby preventing the transmission of inside information from its investment banking to its broker-dealer department and properly regulates recommendations with respect to a security of an investment banking client, the possession of confidential information by the investment banking department should not operate to prohibit the broker-dealer department from executing trades desired to be

executed by a customer. Drawing the line at this point assures on the one hand: no possibility of the improper use of inside information to "tip" trading customers; on the other hand, no misrepresentation and breach of fiduciary duty by the firm to such customers.

In sum, there is a strong public policy in favor of the survival and continued viability of multi-service firms in the securities industry. In order to comply with the securities laws, a multi-service firm must utilize a "Chinese wall". Such firms could not continue to survive if the existence of such "Chinese wall" was *ipso facto* to be deemed to give rise to a cause of action in favor of trading customers complaining of not having been "tipped". Absent a false recommendation as existed in the case at bar, no such cause of action should exist.

CONCLUSION

The decision of the District Court should be affirmed and the certified question answered in the affirmative, with the word "soliciting" therein being carefully limited to its intended meaning of "recommending".

Respectfully submitted,

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ADDENDUM

Statutes and Rules

Securities Exchange Act of 1934

Section 10(b)

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

• • •

To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Rule 10b-5

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate, commerce, or of the mails, or of any facility of any national securities exchange,

(1) to employ any device, scheme or artifice to defraud,

(2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

RENEE SLADE,

Plaintiff-Appellee,

against

SHEARSON, HAMMILL & CO., INC.,

Defendant and Third-
Party Plaintiff-Appellant,

against

NATIONAL BANK OF NORTH AMERICA,

Third-Party Defendant.

State of New York,
County of New York,
City of New York—ss.:

DAVID F. WILSON being duly sworn, deposes and says that he is over the age of 18 years. That on the 16th day of October, 1974, he served two copies of the Brief of Salomon Brothers as Amicus Curiae on See attached list

the attorneys for the See attached list by depositing the same, properly enclosed in a securely sealed post-paid wrapper, in a Branch Post Office regularly maintained by the Government of the United States at 90 Church Street, Borough of Manhattan, City of New York, directed to said attorneys at No. See attached list ( ) N. Y., that being the address designated by them for that purpose upon the preceding papers in this action.

David F. Wilson

Sworn to before me this
16th day of October, 1974.

Courtney J. Brown

COURTNEY J. BROWN
Notary Public, State of New York
No. 31-5[illegible]30
Qualified in New York County
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